Legal Issues in Outsourcing: What Businesses Should Know

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ABSTRACT

Recently, the U.S. has seen a huge growth in offshore outsourcing relationships and experts agree that the first person to consult before negotiating an offshore outsourcing agreement, is a lawyer. However, because this outsourcing phenomenon is relatively new, business people cannot always rely on their lawyers to possess the degree of expertise necessary to grapple with all the legal issues involved. Consequently, businesses should familiarize themselves with the main legal issues with respect to offshore outsourcing, in order to circumvent any unwanted developments later on. This paper will present a high-level overview of offshore outsourcing, and its legal considerations.

INTRODUCTION

Recently, the U.S. has seen a huge growth in offshore outsourcing relationships and experts agree that the first person to consult before negotiating an offshore outsourcing agreement, is a lawyer. However, because this outsourcing phenomenon is relatively new, business people cannot always rely on their lawyers to possess the degree of expertise necessary to grapple with all the legal issues involved. Consequently, businesses should familiarize themselves with the main legal issues with respect to offshore outsourcing in order to circumvent any disastrous developments later on. This paper will present a high-level overview of offshore outsourcing, and its legal considerations.

By way of introduction, outsourcing can be defined as the strategic use of 3rd parties to perform tasks previously handled internally.

Outsourcing can provide many benefits. Among these are (1) lowering of costs for the outsourcing party, (2) compensation for lack of internal expertise, (3) freeing of managerial and governing personnel to focus on their core competencies and high level issues, and (4) availability of best-in-class practices and the latest technology.

Outsourcing has its drawbacks as well. Among these are (1) decrease of in-house expertise; (2) partial or total reliance on a 3rd party, (3) reduction in staff morale, (4) unexpected differences in level of services provided (5) incurrence of higher costs when company is compelled to use its own time and resources to train the provider, (6) incurrence of higher costs due to the provider’s compliance with local laws, (y) unexpected difficulties due to cultural differences.

The types of services that can be outsourced are diverse. In theory, any task that was previously handled internally can be outsourced. As a factual matter, the services that are most popularly outsourced are the following: (1) inventory control; (2) research and development services, (3) data processing services, (4) transcription services, (5) customer call centers, (6) technology services, (7) software development, and (8) business processes.

Steps in the Outsourcing Relationship

The first step in any outsourcing arrangement, is to identify the requirements of the company. The second step is to draft and distribute its Request for Proposals (“RFP”). Again, the vendor should set forth its requirements with clarity, and if possible, in measurable terms. Many times, the vendor may want to include in its RFP, the minimum service levels that it requires, again if possible, in measurable terms.

The third step for the customer, is to review the proposals that it receives and evaluate the various vendors. Certain points that should be kept in mind when choosing the vendor, are the following: (1) Is the vendor financially stable?; (2) Does the vendor have a proven track record? (If possible, the customer should try to obtain references from former customers); (3) Does the vendor have the needed skill sets to fulfill the requirements or will they be training themselves on the customers time and budget, (4) Is the vendor located in a outsourcing “friendly” locale or does it have
to comply with onerous civil regulations and import controls?; and lastly, (5) What legal liabilities might the customer be exposed to when sending business to the vendor’s locale?

After the vendor is chosen, negotiations will be held and an agreement will be drafted between the customer and vendor.

**Terms of Outsourcing Agreement**

The next major task for parties entering into the outsourcing arrangement, is to negotiate and set forth, the terms of the outsourcing agreement (“Agreement”). The Agreement is the crux of the outsourcing arrangement as it will be the guiding document by which the vendor and customer pursue their respective obligations.

The various terms of the Agreement that will be negotiated are the following:

1. The Term of the Agreement;
2. The Services to be Provided (scope of the agreement);
3. Ownership of Intellectual Property (“IP”);
4. Ownership and Confidentiality of Data and Trade Secrets;
5. Delegation of responsibilities;
6. Warranties and Indemnities;
7. Disclaimers;
8. Force Majeure;
9. The Choice of Law and Jurisdiction;
10. The Termination Clause.

**Term of Agreement**

With regard to the Term of Agreement, the customer should negotiate for a short period with renewal options, giving it greater flexibility in continuing with or terminating the outsourcing relationship. A nationwide survey found that the typical term was 5-10 years.

**Services to be Provided**

With regard to the Services to be Provided, it is vital that the customer set forth its expectations as specifically as possible. It is crucial that measures for performance are clear and accurate due to the fact that without them, there are no objective criteria for managing the outsourcing relationship. The agreement should define measurable goals and benchmarks to determine the success or failure of the outsourcing.

The customer may also want a Service Level Agreement to accompany the main contract. The Service Level Agreement (“SLA”) can be viewed as a document that lays out the performance standards with as much detail and specificity as possible. The SLA will set forth the minimum service levels according to a quantifiable metric, and also set forth the penalties for failure to meet the minimum service levels. With respect to the SLA, the issues that usually arise are when to measure service levels (E.g., hourly, daily, weekly, monthly) and who will conduct the measurements.

The customer should also anticipate changes in the nature of services, (such as volume changes to the existing services, or the need for new services), and accordingly, make sure that the Agreement contains the necessary provisions to accommodate these changes.

**Warranties**

A Warranty is quite simply, an assurance. Perhaps the single most important warranty that the customer should expect from the vendor, is the promise that the vendor can and will provide the services as defined in the contract, and that it will accommodate and increase in requirements or any new services that are needed. If the warranty is breached, the vendor will usually be responsible for all legal liability incurred as a result of the breach and the customer may terminate the contract if he so wishes. An indemnity is essentially a promise to “pick up the tab” for problems caused by vendor’s breach of the license agreement.
**Disclaimers**

Disclaimers are contractual provisions that limit liability. The most common disclaimer in an outsourcing relationship is usually the declaration that the vendor will not be liable for any indirect, special, or incidental damages arising out of the use of third party software or services, or arising from the inability of the Customer’s to fulfill its obligations under the Agreement. The Customer should accept that disclaimers will be part of the contract; nevertheless, the Customer should make sure that the disclaimers do not void the Warranty and Indemnity sections.

**“Force Majeure”**

“Force Majeure” literally means "greater force". Force Majeure clauses excuse a party from liability if some unforeseen event beyond the control of that party prevents it from performing its obligations under the contract. Typically, Force Majeure clauses cover natural disasters or other "Acts of God.” This provision sets forth the various conditions whereby the vendor can be excused from performance. Such lapses in performance should be limited to a 30-60 day period. It is important to remember that Force Majeure clauses are intended to excuse a party only if the failure to perform could not be avoided by the exercise of due care by that party. When negotiating Force Majeure clauses, make sure that clause sets forth some specific examples of acts that will excuse performance under the clause, such as wars, natural disasters, and other major events that are clearly outside a party's control. Inclusion of examples will help to make clear the parties' intent that such clauses are not intended to apply to excuse failures to perform for reasons within the control of the parties.

**Ownership Issues**

The determination of ownership for IP existing before the implementation of the outsourcing arrangement is crucial, particularly with regard to termination of the relationship. Without this pre-determination of ownership, the allocation of assets may be nearly impossible. The contract should specify which party owned which IP assets before the outsourcing was implemented. The best manner by which to determine such ownership, is to conduct due diligence of the customer and vendor’s IP. This due diligence process includes identifying the IP involved and its owner; reviewing agreements associated with IP, and identifying IP licensed to 3rd parties.

The partitioning of ownership rights for IP developed during the course of the agreement by either party or their employees and independent contractors is often a complicated task, fraught with much cantankerous negotiation.

There are several approaches to sharing ownership rights regarding IP that is improved or created during the outsourcing arrangement: (1) the customer owns all the IP, with the vendor possessing the possibility of using the IP through a license agreement; (2) the vendor owns all the IP, with the customer taking a license; (3) apportionment of ownership of different IP assets; and (4) joint ownership of such IP.

Of all the aforementioned ways that IP ownership may be determined, the most popular solution seems to be that of joint ownership. Paradoxically, joint ownership one of the least understood and most complicated types of ownership possible as joint ownership laws differentiate between patents, copyrights, and trademarks.

With regard to patents, each joint owner may make, use, sell, and import the patented invention without the consent of the other owners. However, all co-inventors must join in a lawsuit.

With regard to copyrights, each co-owner is entitled to grant non-exclusive licenses to distribute, and copy the copyrighted work. However, each co-owner must account to the owner, for a ratable share of any profits earned from using or licensing the copyright.

With regard to trademarks, joint ownership is viable only in circumstances where the co-owners have in place, a structure to assure joint control over the quality of goods and services to be sold under the mark. Without this structure, the trademark may be legally pronounced as having been split, as it no longer stands for a single quality source, and nullified. In addition, parties considering joint ownership should bear in mind that the rules governing the rights of co-owners differ in many foreign jurisdictions from those of the United States ("U.S.").
Privacy Issues

Unlike the European Union, the U.S. has never enacted a comprehensive privacy law. Rather, its approach has been to enact laws to address particular harms, such as the “Children’s Online Privacy Protection Act” or the “Health Insurance Portability and Accountability Act.”

Nevertheless, laws do exist that impose obligations to maintain reasonable security. Pursuant to these laws, the Agreement must specify that the customer retains ownership of all data it submits to the vendor and that the data is to be kept strictly confidential. If the vendor will have direct or indirect access to information regarding the customer’s employees, customers, vendors, or partners, a mutually acceptable protocol for handling and processing this information must be put into place.

Furthermore, to the extent that the customer has posted or distributed privacy statements, the customer will be expected to be in full compliance of these statements with regard to ownership and confidentiality of data.

Jurisdictional Issues

The agreement should set forth the following choice-of-law and jurisdictional issues: (1) Which country will have jurisdiction over disputes?; and (2) Which country’s substantive law will apply to disputes? These points are often hard fought for obvious reasons; each party wants its own locale to have jurisdiction and its own locale’s laws to be applied.

Oftentimes, the parties will agree to the jurisdiction and substantive law of the locale where the “breaching activity” occurred. However, with the advent of the Internet, this solution is much less efficacious as geographical determination of a crime occurring in cyberspace is nearly impossible.

Another question that arises is whether the parties desire alternative dispute resolution mechanisms, such as arbitration. Most significantly, the customer must understand that certain courts will feel free to override contractual provisions as to jurisdiction and governing law.

Termination Issues

The termination clause is hugely important as it sets forth the conditions under which the customer may exit the outsourcing relationship. The following are a list of common reasons whereby the customer may exercise termination rights:

1. Termination for convenience;
2. Termination for material breach;
3. Termination for financial crisis;
4. Termination for change of control of vendor;
5. Loss of license;
6. Termination for failure to meet service and performance levels;
7. Termination for breach of contract;
8. Termination for non-payment.

The customer will always want the right to terminate for convenience. The problem with this approach is that the vendor will usually insist on an equivalent right.

The customer will want the right to terminate for the vendor’s “Material Breach.” The party’s definition of “Material breach” is not cut and dry and may necessitate lengthy negotiations as the parties argue over what set of conditions constitute materiality. One possible solution is for the customer to lay out in the contract, specific instances that constitute material breach. The danger of this approach is that it may potentially miss some set of circumstances. Another possible contractual solution is to assign a broad definition to “material breach.” However, the problem with this approach is that it often leads to disagreement as to whether the set of circumstances at issue fall under the definition. A possible contractual avenue is for the customer to contractually give itself the right to determine materiality; however, this “solution” will almost always be hotly contested by the vendor.

A financial crisis on the part of the vendor is another set of circumstances whereby the customer will desire the ability to terminate. Indeed, the customer does not want to find itself stuck in a situation where the vendor cannot properly perform its duties due to financial difficulties. The customer will want a provision that lays forth a broad general definition of “financial difficulties.” As a corollary, the customer will also want to have sole decision making power in determining whether there exist financial difficulties. A compromise approach may be for the vendor and
customer to agree upon what set of circumstances constitute “financial difficulties,” and lay out in detail, the rights and obligations of both parties.

The customer may also want the ability to terminate for a change of control of the vendor. Usually, the customer exploits this right in those situations where the ownership of the vendor is greatly important to the customer.

The customer will also want termination rights for those circumstances whereby the vendor loses a license that is necessary to provide services. Finally, the customer will want the ability to terminate the agreement when the vendor fails to meet service and performance levels. In order to avoid argument as to what constitutes “failure,” the contract should lay out with specificity, the exact metrics according to which, failure can be measured.

Next, the parties must set forth their respective rights upon termination. The customer will want to be able to compel the supplier to assign relevant third party contracts and licenses, to either the customer or a new supplier. The customer may need the option to purchase necessary equipment owned by the vendor. Lastly, where the vendor uses its own IP in the provision of services and such IP cannot be obtained in the marketplace, the customer will want the ability to require a license for itself or a new vendor (at least on a temporary basis).

Employee transfers at termination can be a crucial point when the contract is being terminated. The customer may need to retain currently staffed employees due to their familiarity with the customer’s project. In general, there are “at will” employment jurisdiction, and “acquired rights” jurisdictions. If the vendor is located in an “at will” jurisdiction, employees are not automatically transferred. The customer must make offers of employment to those employees it desires to hire from the vendor. However, if the vendor is located in an “acquired rights” regime, the employees will automatically transfer to the customer.

Statutory Issues

Lastly the customer must be aware of several statutes to which it may be subject. The first is the Sarbanes Oxley Act. This act was passed in order to restore investor confidence in the marketplace after several crisis of integrity, such as the Enron debacle. The act applies to public companies that prepare or issue audit reports for other public companies. For purposes of this paper, this act declares that organizations are responsible for (1) composing such audit reports for their offshore vendors, and (2) ensuring that they have in place, adequate controls over financial reporting by their offshore vendors.

Next in our discussion, is the Health Insurance Portability and Accountability Act. The act was passed in order to simplify and improve the administration of health insurance, as part of an effort to curb fraud and abuse of the health care industry. The act applies to any entity that provides, or pays for the cost of medical care, including employee benefit plans that provide medical care directly or indirectly through insurance or reimbursement. Relevant to this paper, covered entities are required to execute business associate agreements with offshore vendors that will have access to personally identifiable health information. In addition, customers must make sure that specific privacy and security obligations are placed on their offshore outsourcers.

CONCLUSIONS

In conclusion, offshore outsourcing can potentially provide significant cost savings and time. However, as discussed above, there exist many legal considerations that an entity must consider before and during the outsourcing arrangement. To reiterate, due to the relative “newness” with regard to the proliferation offshore outsourcing, case laws and statutory law are still being developed and tested. In this context, legal counsel can not be relied upon, to be fully abreast of these changes. Consequently, it is vital that business entities educate themselves, at least on a rudimentary basis, with the major legal topics concomitant with offshore outsourcing.
BIBLIOGRAPHY


